

Multistate Tax Commission



Hearing Officer's Report

Recommendation Concerning Enactment of a Uniformity Provision on Reporting Options For Non-resident Members of Pass-through Entities

April 15, 2002

I. Introduction.

By direction of the Multistate Tax Commission ("MTC") Executive Committee, the appointed hearing officer has held a public hearing to gather public comment on the MTC proposed recommendation for enactment by the states of a uniformity provision concerning reporting options for non-resident members of pass-through entities. The Executive Director appointed Frank D. Katz, Deputy General Counsel, to be the Hearing Officer. See Exhibit A. Set out below is the Hearing Officer's Report and recommendations for future action.

II. Background.

The issue of filing options for members of pass-through entities was brought to the attention of the Executive Director of the MTC by a taxpayer seeking a simpler way of reporting state income taxes to multiple states for multiple members of pass-through entities. The Executive Director directed the inquiry to the Uniformity Committee, which referred the matter to the Income and Franchise Tax Subcommittee. The subcommittee discussed the matter at several meetings and developed a uniformity provision to simplify the income tax reporting and paying obligation for non-resident members.

The full committee approved the recommendation and the Executive Committee authorized a public hearing for public comment.

The proposal sent to hearing by the Executive Committee reads as follows:

Section 1. Definitions.

A. “Pass-through entity” means a corporation that for the applicable tax year is treated as an S Corporation under [IRC §1362(a), or State Tax Code §], and a general partnership, limited partnership, limited liability partnership, or limited liability company that for the applicable tax year is not taxed as a corporation [for federal tax purposes] [under the state’s check-the-box regulation];

B. “Member” means [optional additional language: *an individual who is*] a shareholder of an S corporation, a partner in a general partnership, a limited partnership, or a limited liability partnership, or a member of a limited liability company.

Section 2. Composite Return Authorized.

A. A pass-through entity may file a composite income tax return on behalf of electing nonresident members reporting and paying income tax at the highest marginal rate provided in [state tax rate provision] on the member’s pro rata or distributive share of income of the pass-through entity from doing business in, or deriving income from sources within, this State.

B. A non-resident member of a pass-through entity whose only source of income within a state is from pass-through entities may elect to have the pass-through entities on composite returns filed pursuant to this section report and pay income tax due on the member’s pro rata or distributive share of income passed through to the member by each entity from doing business in, or deriving income from sources within, this State.

C. The [tax agency] may establish procedures or promulgate rules and regulations necessary to carry out the provisions of this section.

D. A nonresident member that has been included in a composite return may subsequently file an individual income tax return and shall receive credit for tax paid on the member’s behalf by the pass-through entity with the composite return.

Section 3. Member Agreements; Mandatory Payments.

A. With respect to each of its non-resident members, a pass-through entity shall for each tax year (1) timely file with the [State taxing authority] an agreement as provided in subsection B, and (2) make a payment to the State as required in subsection C. A pass-through entity that timely files an agreement as provided in subsection B with respect to a non-resident member for a tax year shall be considered to have timely filed such an agreement for each subsequent tax year.

B. The agreement referred to in subsection A is an agreement of the non-resident member

1. to be subject to the jurisdiction of the State for purposes of the collection of income taxes owed on the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State; and either
2. to be included on a composite return that is filed by the pass-through entity accompanied by payment of tax due on the member's income from the pass-through entity, or
3. to file a return in accordance with the provisions of [individual income tax return filing requirement] and to make timely payments of all taxes imposed on the member by this State with respect to the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State.

C. If no agreement is filed in which the non-resident member consents to be included in a composite return that the pass through entity does, in fact, file for any tax year and if the non-resident member fails to file a [state] individual income tax return reporting the member's pro rata or distributive share of the income of the pass-through entity from doing business in, or deriving income from sources within, this State or fails to pay any tax due thereon, the pass through entity shall be liable for tax on such income at the highest marginal rate applicable to individuals. The pass-through entity shall be entitled to recover the payment made pursuant to the previous sentence from the non-resident member on whose behalf it paid tax.

III. Public Comment at Hearings

1. A hearing was held on March 18, 2002 at 9:30 a.m. at the Doubletree Hotel at Reid Park in Tucson, AZ. Notice of the Hearing is attached as Exhibit B. Certification of René Blocker affirming proper dissemination of the Notice is attached as Exhibit C. The following comments were received at the hearing.
 - Don Jones, Oregon Department of Revenue, wondered whether there was any constitutional question on the validity of requiring the pass-through entity to pay tax on the income of the entity apportioned and distributed to individual members.
 - Elisa Wong from the Arizona Department of Revenue suggested that making the entity liable for tax on income it earned in a state is really no different from making a C Corporation liable for its income. She saw no constitutional issue here. Others agreed with her.
 - Elisa Wong also expressed concern what happens when a pass-through entity terminates its existence after making a big distribution to its members of the profits from the deal it was set up for. If members fail to pay tax, triggering the circumstance where the entity would be liable, there may then be no entity left to shoulder that liability. Only withholding of distributions can fully protect the states in these circumstances. Others present agreed with that analysis.
 - Jennifer Hays, Kentucky Department of Revenue and Chair of the Income and Franchise Subcommittee of the Uniformity Committee, emphasized the need to show that there is a compliance problem. Legislatures may be reluctant to impose the derivative liability on the entities unless they know there is a real compliance problem with nonresident members who fail to pay the tax.

IV. Summary of Written Responses.

1. American Bar Association State and Local Tax Committee's Subcommittee on Income and Franchise Taxes sent a written comment on April 2, 2002. A copy of the submission is attached as Exhibit D.
 - In an Introduction, the ABA subcommittee noted that its response should not be construed as endorsing a suggestion that members "are or, as a matter of policy, should be subject to income taxation in states in which they neither reside or have

physical presence.” It also noted that the proposal fails to distinguish between general and limited partners or active participants and passive investors.

- In its first substantive comment, the subcommittee suggests that the proposal “should not impose derivative liability on pass-through entities without providing the entities with authority to withhold taxes from cash distributions” and “no derivative liability should attach where a member has a distributive share of the entity’s income but does not receive an actual cash distribution.” It based its reasoning on the fact that the entity cannot force a member to pay tax, that the monitoring required imposes an unreasonable burden, and the entity may not learn of a members failure to pay tax until years after the members has left the entity, making reimbursement difficult or impossible.
 - In its second comment, the subcommittee suggests the proposal should apply only to non-entity members, to individuals. They don’t give a clear reason why, but note there are some inconsistencies in the proposal if it is intended to apply to entities. For instance, in the derivative liability section, the entity may be liable for its members unpaid tax at “the highest marginal rate applicable to individuals.”
 - In its third comment the subcommittee suggests the proposal should explicitly credit members with any taxes paid by the entity on member’s behalf and allow members access to tax agency records of payments by an entity on members’ behalf.
 - In its fourth comment, the subcommittee suggests the proposal be split into two, one covering the imposition of direct and derivative liability for income taxes and the other on tax reporting options.
 - Finally, the subcommittee suggests a different title, highlighting the fact that the proposal purports to impose income tax payment obligation on non-resident members and derivative liability on the entity.
2. The AICPA Composite Return Working Group submitted written comments on April 5, attached as Exhibit E, outlining overall critical issues and considerations. Any composite filing proposal
- must be elective and voluntary
 - must not make a pass-through entity liable for members’ tax
 - must be easily administered and uniform as to eligibility for composite return,
 - must exempt any tax attributable to non-cash income, and
 - must consider NOLs in computation of income.

The AICPA also suggested considering issues

- of compensation for the administrative burden placed on the pass-through entities,
- of choice of tax rates and uniformity in the tax base, and
- of crafting a proposal that could be adopted by regulation rather than statute.

Finally, the AICPA suggested the MTC combine consideration of composite returns with an overall updating of MoSCITA to apply to all pass-through entities.

V. Hearing Officer's Recommendations

The ABA Subcommittee raises some important issues. Clearly its primary concern lies with imposing income tax liability on non-resident members and derivative liability on the entities. Comments four and five suggesting the MTC split the proposal in two and re-title it are intended to highlight these issues. The liability of non-resident members would appear to be a matter of current law. The derivative liability issue is not.

On the issue of non-resident member's liability, the Hearing Officer expects that states will want to continue to enforce the underlying agreement implicit in the current taxing scheme for pass-through entities. States exempt pass-through entities from tax on income earned by the entity from doing business and being present in the state with the understanding that the liability for the tax, like the income, passes through to the members. States clearly expect that those members will pay the tax. It is not reasonable, then, to allow the non-resident members to escape paying that tax by claiming that they, as contrasted to the pass-through entity, are not physically present in the state or do not derive income from the state on which they owe tax. If the nonresident members continue to make those claims and play those games, States may be expected to respond by simply taxing the entity, where nexus is undisputed, and not continue to play hide and go seek with its members.

A more difficult issue is raised in enlisting the entity in efforts to collect tax on income passed through to non-resident members. A composite return inevitably does that, and that degree of entity involvement seems to be acceptable. The issue is really whether additional enforcement responsibility should be given the entity. The approach taken by the current draft purports to allow the member the greatest freedom. She can opt to join a composite return and have the entity file and pay for her or, by filing an agreement to pay, she can get her distributions directly from the pass-through entity without withholding and pay the tax on her own. Only if the member fails on all counts, no agreement or no payment, does ultimate liability shift to the entity.

The ABA Subcommittee points out that this solution does cause significant problems for the entity. First, it must monitor to ensure that various members who promise to pay do pay. Second, it can face significant liability far down the road when its ability to recover from the noncompliant member is impaired if not eliminated. Third, under the current proposal it does not have authority to withhold the tax owed on distributions made to members to protect it from a noncompliant member. Finally, its liability is not limited to paying tax on cash distributions, which exacerbates the collection difficulties against the uncooperative member..

The lack of authority to withhold can easily be fixed by a sentence in Section 3(C) as follows. “The pass-through entity may withhold from any distribution to a member the income tax due to this State from the member on the distribution at the highest marginal rate.”

But should the proposal place ultimate liability on the entity if the nonresident member promises to pay but does not? Does that create a contingent liability that may well be invoked too late, inevitably leaving either the entity or the state holding the bag? Moreover, should the entity’s liability for member’s tax be limited to cash distributions where at least there was some money from which to take the tax?

In many respects, the answer to all of these concerns is mandatory withholding on cash distributions. This was initially included as part of the proposal but removed by the Uniformity Committee in response to perceived objections from taxpayers’ representatives. But it seems to be the best answer to the legitimate questions raised by the ABA Subcommittee as well as the concerns expressed by state representatives at the hearing, particularly with regard to entities established for a single deal with a one-shot distribution that leaves chasing the entity for tax owed by noncompliant members futile. Withholding requires the entity to pay over members’ tax only from members’ distributions, never from its own pocket. This would appear to meet one of the AICPA’s concerns, also, that the entity not be liable for member’s tax. Withholding requires payments concurrently with distributions, so no monitoring or fear of future contingent liability is created. Withholding is the norm for many forms of income, from wages and salaries to certain other kinds of interest and dividend payments. Admittedly, withholding is limited to cash distributions and therefore can miss some deemed income attributable and taxable to members. But those are relatively unusual, and should we be letting the arcane drive the ordinary? Limiting entity responsibility to cash payments also meets another of the AICPA’s criteria.

Your Hearing Officer recommends that the Executive Committee reconsider the issue of withholding, and consider substituting a withholding requirement for the derivative liability currently in Subsection 3(C).

With regard to the ABA Subcommittee's comment concerning whether the proposal should apply only to non-entity members, as currently drafted the proposal leaves that decision to the implementing states. The ABA does not really give much reason to eliminate that option, but does correctly point out that if the option is retained, the various references to "individuals" or "individual income tax return" should be broadened.

Finally, the proposal intended that the member be credited with any tax paid on the member's behalf by the entity, whether as part of a composite return, through withholding, or because of the failure of the member to pay. If it serves clarity, a final sentence could be added to the proposal as follows. "Any payment by the entity of the member's tax liability shall be credited to the member and the [tax agency] may inform the member of any such payment."

Your Hearing Officer believes the Executive Committee has three options at this point. First, the technical issues raised by the ABA subcommittee can be met by revising the proposal as set forth in Exhibit F. This revised version can be submitted to a Bylaw 7 survey of Member States.

Secondly, if the Executive Committee wishes to continue with this proposal but has concern about the way the entity's derivative liability is currently handled and believes that perhaps substituting a withholding requirement might improve it, your Hearing Officer recommends sending the proposal back to the Uniformity Committee for redrafting and further public hearing. A potential revision of the proposal to substitute withholding is attached as Exhibit G.

Finally, the Executive Committee may wish to consider the recommendation of the AICPA to delay proceeding on a composite return proposal separately in favor of a more comprehensive revision of MoSCITA to include all pass-through entities. This option would obviously entail considerably delay and your Hearing Officer does not recommend that delay.

Respectfully submitted April 15, 2002,

Frank D. Katz

Exhibits Attached to the Report of the Hearing Officer
Regarding the Proposed Recommendation to States
for Enactment of a Uniform Provision Concerning Reporting
Options For Non-Resident Members Of Pass-Through Entities

- Exhibit A: Memorandum of Appointment of Hearing Officer
- Exhibit B: Notice of Public Hearing.
- Exhibit C: Certificate of René Blocker attesting to proper notice of hearing.
- Exhibit D. Written Response of the American Bar Association State and Local Tax Committee's Subcommittee on Income and Franchise Taxes
- Exhibit E: Written Response of the American Institute of Certified Public Accountants (AICPA).
- Exhibit F: Technical Revision of Proposed Statutory Language on Reporting Options for Non-resident Members of Pass-through Entities.
- Exhibit G: Revised Proposed Statutory Language on Reporting Options for Non-resident Members of Pass-through Entities substituting withholding.



Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

Memorandum of Appointment of Hearing Officer

To: Record of the Hearing on Uniformity Provision Concerning Reporting Options For Non-Resident Members Of Pass-Through Entities

From: Dan R. Bucks, Executive Director

Date: November 15, 2001

Re: Appointment of Hearing Officer for Proposal on Uniformity Provision Concerning Reporting Options For Non-Resident Members Of Pass-Through Entities

The Executive Committee of the Multistate Tax Commission approved at its meeting held November 1, 2001, the conduct of a public hearing on the Uniformity Provision Concerning Reporting Options For Non-Resident Members Of Pass-Through Entities. Pursuant to that action and the Multistate Tax Compact, I hereby appoint Frank D. Katz, Deputy General Counsel, as Hearing Officer for this proposal. I further request that he proceed with the conduct of this hearing.

Dan R. Bucks, Executive Director

EXHIBIT A



NOTICE OF PUBLIC HEARING

Regarding a

UNIFORMITY PROPOSAL CONCERNING REPORTING OPTIONS FOR NON-RESIDENT MEMBERS OF PASS-THROUGH ENTITIES

The MULTISTATE TAX COMMISSION will conduct a public hearing to obtain comments from interested parties on a proposed recommendation to States for enactment of a uniform provision concerning reporting options for non-resident members of pass-through entities.

The proposal permits pass-through entities to file composite returns reporting and paying tax for electing non-resident members on their distributive share of income from the pass-through entity from in-state sources. Only non-resident members whose entire in-state income will be reported on composite returns may join a composite return. Eligible non-resident members may choose to file an individual return or may join a composite return. If they do join a composite return, they may subsequently file an individual income tax return, if required or desired, and be credited with any tax paid with the composite return. The State may require the pass-through entity to pay tax owed by non-resident members who elect to file an individual return but then fail to file and pay tax due. The proposed language is attached as Exhibit A.

The hearing on this proposal will be held at the time, date and location specified below:

MONDAY, MARCH 18, 2002 AT 9:30 A.M. (MST)

Doubletree Hotel at Reid Park
The Boardroom
445 South Alvernon
Tucson, AZ 85711

Public comment is sought on whether the MTC should recommend adoption of the proposal. The full text of the proposal has been provided with this notice. (The proposal and this notice are available on the MTC's website at www.mtc.gov). General comments about the proposal as well as comments regarding the specific language of the provisions are encouraged.

All comments received as part of the hearing process will be set forth in a hearing officers' report that will be submitted to the MTC Executive Committee. The MTC Executive Committee will read what you say and then will consider the proposal for appropriate action. *See* The MTC's Uniformity Recommendation Development Process at step seven, available at www.mtc.gov/uniform/9steps.htm

EXHIBIT B

The hearing officer for this matter is Frank D. Katz. Please submit all questions, comments and correspondence regarding this hearing matter to: Hearing Officer Frank D. Katz, Multistate Tax Commission, 444 N. Capitol Street, N.W., Suite 425, Washington, D.C. 20001-1538, Phone: (505) 982 4351, Fax: (505) 982 4379, E-mail: fkatz@mtc.gov

All interested parties are invited to participate in this public hearing. Parties wishing to make formal oral presentations are requested to notify the hearing officer in writing at least two (2) working days prior to the hearing date. Written comments are acceptable and encouraged. They may be submitted at any time prior to or on the hearing date or by such later date as may be announced at the closing of the public hearing. Interested parties may participate by telephone. Please contact the hearing officer for specific instructions on how to connect by telephone.

Exhibit A

Proposed Statutory Language on Reporting Options for
Non-resident Members of Pass-through Entities

Section 1. Definitions.

A. “Pass-through entity” means a corporation that for the applicable tax year is treated as an S Corporation under [IRC §1362(a), or State Tax Code §], and a general partnership, limited partnership, limited liability partnership, or limited liability company that for the applicable tax year is not taxed as a corporation [for federal tax purposes] [under the state’s check-the-box regulation];

B. “Member” means [optional additional language: *an individual who is*] a shareholder of an S corporation, a partner in a general partnership, a limited partnership, or a limited liability partnership, or a member of a limited liability company.

Section 2. Composite Return Authorized.

A. A pass-through entity may file a composite income tax return on behalf of electing nonresident members reporting and paying income tax at the highest marginal rate provided in [state tax rate provision] on the member’s pro rata or distributive share of income of the pass-through entity from doing business in, or deriving income from sources within, this State.

B. A non-resident member of a pass-through entity whose only source of income within a state is from pass-through entities may elect to have the pass-through entities on composite returns filed pursuant to this section report and pay income tax due on the member’s pro rata or distributive share of income passed through to the member by each entity from doing business in, or deriving income from sources within, this State.

C. The [tax agency] may establish procedures or promulgate rules and regulations necessary to carry out the provisions of this section.

D. A nonresident member that has been included in a composite return may subsequently file an individual income tax return and shall receive credit for tax paid on the member’s behalf by the pass-through entity with the composite return.

Section 3. Member Agreements; Mandatory Payments.

A. With respect to each of its non-resident members, a pass-through entity shall for each tax year (1) timely file with the [State taxing authority] an agreement as provided in subsection B, and (2) make a payment to the State as required in subsection C. A pass-through entity that timely files an agreement as provided in subsection B with respect to a non-resident member for a tax year shall be considered to have timely filed such an agreement for each subsequent tax year.

B. The agreement referred to in subsection A is an agreement of the non-resident member

4. to be subject to the jurisdiction of the State for purposes of the collection of income taxes owed on the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State; and either
5. to be included on a composite return that is filed by the pass-through entity accompanied by payment of tax due on the member's income from the pass-through entity, or
6. to file a return in accordance with the provisions of [individual income tax return filing requirement] and to make timely payments of all taxes imposed on the member by this State with respect to the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State.

C. If no agreement is filed in which the non-resident member consents to be included in a composite return that the pass through entity does, in fact, file for any tax year and if the non-resident member fails to file a [state] individual income tax return reporting the member's pro rata or distributive share of the income of the pass-through entity from doing business in, or deriving income from sources within, this State or fails to pay any tax due thereon, the pass through entity shall be liable for tax on such income at the highest marginal rate applicable to individuals. The pass-through entity shall be entitled to recover the payment made pursuant to the previous sentence from the non-resident member on whose behalf it paid tax.



Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To: Frank D. Katz, Deputy General Counsel and Hearing Officer for MTC
Uniformity Proposal Concerning Reporting Options for Non-resident
Members of Pass-through Entities

From: René Blocker, Deputy Director

Date: April 9, 2001

Subject: Certification of mailing of "Notice of Public Hearing Regarding a
Uniformity Proposal Concerning Reporting Options for Non-resident
Members of Pass-through Entities."

In compliance with the Multistate Tax Commission Bylaw 7, the "Notice of Public Hearing Regarding a Uniformity Proposal Concerning Reporting Options for Non-resident Members of Pass-through Entities" was mailed on February 12, 2002, to the names on the mailing lists maintained by the MTC.

EXHIBIT C

March 28, 2002

Frank D. Katz
Multistate Tax Commission
444 North Capitol Street
Suite 425
Washington, D.C. 20001

**Re: Multistate Tax Commission's Proposed Statutory Language On
Reporting Options for Non-Resident Members of Pass-Through
Entities**

Dear Mr. Katz:

I am enclosing comments on the proposed model statute referred to above, as prepared by members of the State and Local Tax Committee's Subcommittee on Income and Franchise Taxes. Substantive contributions to these comments were made by David A. Fruchtmann, Winston & Strawn, Chicago, Illinois, Robert Joe Hull, Bracewell & Patterson, Houston, Texas, and Steven Soles, Dechert, Philadelphia, Pennsylvania. These comments were reviewed by a member of our Committee on Government Submissions.

These comments represent the individual views of the members who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

Sincerely,

Richard M. Lipton
Chair, Section of Taxation

Enclosure

EXHIBIT D

COMMENTS CONCERNING Multistate Tax Commission's
Proposed Statutory Language On Reporting Options for
Non-Resident Members of Pass-Through Entities

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association, the Section of Taxation, or the individuals' law firms.

These comments were prepared by members of the Committee on State and Local Taxation's Subcommittee on Income and Franchise Taxes. Principal responsibility was exercised by David Fruchtman. Substantive contributions were made by Robert Joe Hull and Steven Soles. The Comments were reviewed by Arthur Rosen of the Section of Taxation's Committee on Government Submissions.

Although members of the Section of Taxation who participated in preparing these Comments may have clients who would be affected by the tax principles addressed by these Comments or may have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

David Fruchtman
312/558-7522
dfruchtman@winston.com

March 28, 2002

March 28, 2002

**Comments On Multistate Tax Commission's Proposed Statutory
Language On Reporting Options for Non-Resident Members of
Pass-Through Entities**

I. Introduction

We appreciate this opportunity to comment on the Multistate Tax Commission's ("MTC") "Proposed Statutory Language On Reporting Options for Non-Resident Members of Pass-Through Entities" (the "Model Statute") (copy attached). Our review of the Model Statute is intended to assist the MTC by providing a perspective of attorneys whose practices focus on state and local tax issues; however, our comments should not be construed as endorsing a suggestion that partners, LLC members or S corporation shareholders are or, as a matter of policy, should be subject to income taxation in states in which they neither reside nor have physical presence.

We note that the Model Statute does not distinguish between general and limited partners (or between active participants and passive investors, or between board managed and member managed LLCs). Whether such distinctions are appropriate (or required) has been addressed with conflicting results by state courts¹ and administrative tribunals.² Under those circumstances, our only observation is that the need for such distinctions must be determined on a state-by-state basis.

With that preface, we offer the following comments.

II. COMMENTS

A. The Model Statute should not impose derivative liability on pass-through entities without providing the entities with the authority to withhold taxes from cash distributions. We do not believe that the imposition of derivative liability on an entity is justified unless the entity has the ability to avoid that liability by withholding income taxes from its members' distributive income. However, the Model Statute allows for derivative liability to be imposed in such circumstances.

The Model Statute, in Section 3.C., imposes liability on a pass-through entity if a non-resident member chooses not to participate in a composite return but then fails to pay income taxes on his distributive share of the entity's income earned in the state. Of course, the

¹ See e.g. Borden Chemicals and Plastics, L.P. v. Zehnder, 726 N.E. 2d 73 (App. Ct. 1st Dist. 2000).

² See e.g. Appeal of Amman & Schmid Finanz AG, California State Board of Equalization, No. 96-SBE-008 (April 11, 1996) and Secretary of Revenue of North Carolina v. Perkins Restaurant, Inc., North Carolina Tax Review Board, Administrative Decision 351 (January 28, 1999).

entity has no ability to force a member to pay state income taxes. Nor, under the Model Statute, does the entity have the authority to withhold taxes from distributions to members. The imposition of derivative liability on the entity in such circumstances is unfair because the entity lacks the ability to control the payment of tax. For the same reason, no derivative liability should attach where a member has a distributive share of the entity's income but does not receive an actual cash distribution. Here again, the entity has no mechanism to avoid such derivative liability.

As additional practical considerations, many pass-through entities operate in several states and have hundreds if not thousands of members. The monitoring required by the statute imposes an unreasonable burden on such entities. Moreover, an entity may not learn of a member's alleged failure to pay income tax until years after the member has left the entity, at which time it may be difficult or impossible for the entity to obtain information or reimbursement from the member.

We suggest the following revisions: (1) We recommend the addition of a subsection authorizing entities to withhold state income taxes from a non-resident member's cash distributions unless the member provides a statement agreeing to be subject to the state's income tax jurisdiction. We also recommend that the subsection provide that the receipt of such a statement will excuse the entity from all liability for the member's taxes owed to the state. (2) We recommend the addition of a subsection stating that an entity's derivative liability is limited to the income tax imposed on the amount of cash distributed to the non-resident member whose taxes are at issue. Alternatively, the subsection could provide that the entity's liability is limited to the amount of cash distributed to the particular member.³

B. The Model Statute should apply only to non-entity members. We recommend that the Model Statute state that it applies to individuals only, rather than leaving to the states' discretion whether to include entities within its reach. The statute seems to have been drafted with non-entity members in mind. For example, under the derivative liability provision, the pass-through entity may be liable for its members' unpaid taxes determined at "the highest marginal rate applicable to individuals." However, no consideration seems to have been given to the different amount of derivative liability that might arise from distributions to members that are entities. There does not appear to be any justification for a mismatch that causes the amount of a pass-through entity's derivative liability to be different from the amount of the member's primary liability. As a second example, it is not clear what the Model Statute intends for pass-through entities that are members of another pass-through entity. What is the effect of such a member-entity agreeing to be "subject to the jurisdiction of the State for purposes of collecting income taxes owed on" its share of distributive income?

These may not be the only areas in which the Model Statute raises questions as to its application to entities. We therefore recommend further analysis before the reach of the statute is extended beyond individuals.

³ See e.g. Maryland Administrative Release No. 6 (Rev. 8/31/01).

C. The Model Statute should include a provision crediting members with all taxes paid to the state. The Model Statute holds a member liable for income tax on his share of the pass-through entity's income earned in the state, holds the entity liable for the member's unpaid taxes, and grants to the entity the ability to require reimbursement from members whose income taxes were paid by the entity. However, the Model Statute does not provide a dollar-for-dollar credit to members whose taxes were paid by the entity. To protect members from having to pay the same tax twice, we recommend that the Model Statute include a subsection stating that income taxes paid to a state in satisfaction of a member's liability shall be fully credited to the member. The availability of this credit should not be affected by whether the member or the entity made the payment to the state. Nor should the availability of the credit be dependent on the member reimbursing the entity for taxes the entity paid to the state on the member's behalf.

Further, in recognition of the fact that the member may no longer have access to the entity's tax information, the member should have the ability to require a state to provide a statement of the amount of taxes paid to the state in full or partial satisfaction of the member's income tax liability.

D. The Model Statute should be split into two Model Statutes. The Model Statute actually addresses two issues: (1) Imposition of direct and derivative liability for income taxes, and (2) Tax reporting options. There is no apparent advantage to the joining of these issues into a single statute. In addition, the provision imposing liability is much more likely to be controversial than is the reporting provision. Therefore, we recommend separating the statute into two proposals. In addition, consistent with the MTC's desire for simplified tax reporting (a desire with which we agree), we recommend the inclusion of a statement with the Model Statutes clearly stating the MTC's belief that the composite reporting Model Statute should be enacted if the tax liability Model Statute is enacted.

E. The caption to the Model Statute should be revised to describe more accurately its contents and effect. The current caption of the Model Statute, "Multistate Tax Commission's Proposed Statutory Language On Reporting Options for Non-Resident Members of Pass-Through Entities," indicates that the proposal addresses taxpayer reporting options. However, the proposal is far more significant for its imposition of tax liabilities on non-resident members and pass-through entities. State legislators, revenue departments and taxpayers who are being asked to consider the Model Statute should be provided with a caption that is descriptive of its most important aspects. If the Model Statute is not split into two Model Statutes, we recommend the revision of its caption to be: "Proposed Statutory Language Imposing Income Tax Payment Obligations on Non-Resident Members of Pass-through Entities and Income Tax Collection/Derivative Liability on Pass-Through Entities."

II. SUMMARY

The Model Statute raises a number of important legal and policy issues. The core issue is, of course, whether income earned by non-resident partners should be subject to income taxation in the states in which the partnership earns the income. We believe that issue must be addressed on a state-by-state basis. We believe that incorporation of the recommended revisions will focus discussion at the state level by avoiding issues that the Model Statute does not appear to have been intended to raise.

Date: 4/4/2002

To: Frank Katz, Hearing Officer, MTC

From: AICPA Composite Return Working Group

RE: Comments and Observations Related to the MTC Uniformity Proposal for Composite Returns

This is to provide you with the preliminary comments of the AICPA working group related to the MTC's Uniformity proposal for state composite returns. The AICPA supports uniformity and administrative ease with respect to composite filing options for pass-through entities. We have identified some overall critical issues with the current proposal, as well as some overall observations as to how to comprehensively address composite filing for pass-through entities.

Our understanding of the initiative and purpose behind this proposal is twofold:

- 1) The cost of collecting tax on non-resident individuals, and the related administrative burden for both taxpayers and the states may be relieved through this process;
- 2) The MTC has received requests from tax practitioners to pursue uniformity among the states in this area as the administrative burden related to large, multistate pass-through entities is significant due to the lack of uniformity.

Overall Critical Issues and Considerations

The uniform composite filing proposal must have the following characteristics:

- ☐ Composite filing is elective and voluntary.
- ☐ The pass-through entity does not become liable for any taxes as a result of members/owners not paying their individual liabilities. The pass-through entity cannot be converted to a taxpayer through this type of administrative process.
- ☐ Administrative ease and uniformity as to eligibility for composite return filings.
- ☐ Exemption from payment of tax attributable to non-cash income or "phantom" income.
- ☐ Net Operating Losses must be given consideration in the computation of composite taxable income.

Consideration must be given to the following issues related to a uniform composite return proposal:

- ☐ In essence, the proposal shifts a large part of this administrative burden. The pass-through entities should be compensated for the new burden shifted to them.
- ☐ Computation of tax paid on the composite return, e.g. using the highest marginal rate, lack of uniformity in the tax base.
- ☐ There are provisions in the current draft of the proposal, which cannot be adopted through regulation and will require statutory provisions, thus significantly protracting the timeframe related to this proposal.

Overall Observations and Recommendation

As an overall observation, we know that many of these issues were previously addressed through a uniformity provision in MoSCITA, which was recommended by the MTC in August 1991. We also understand that the MTC is desirous of updating MoSCITA. Our recommendation related to the current proposal, as well as the initiative to update MoSCITA, is that both initiatives be combined into one effort. In this manner, a broader, thorough analysis of composite filing related to all pass-through entities can be addressed and covered in one proposal. We look forward to working with the MTC and

other interested parties in this effort. Thank you for the opportunity to provide you with our comments and observations.

EXHIBIT E

Technical Revisions of Proposed Statutory Language on Reporting Options
for Non-resident Members of Pass-through Entities

[Additions are underlined, deletions ~~struck through~~]

Section 1. Definitions.

A. “Pass-through entity” means a corporation that for the applicable tax year is treated as an S Corporation under [IRC §1362(a), or State Tax Code §], and a general partnership, limited partnership, limited liability partnership, or limited liability company that for the applicable tax year is not taxed as a corporation [for federal tax purposes] [under the state’s check-the-box regulation];

B. “Member” means [optional additional language: *an individual who is*] a shareholder of an S corporation, a partner in a general partnership, a limited partnership, or a limited liability partnership, or a member of a limited liability company.

Section 2. Composite Return Authorized.

C. A pass-through entity may file a composite income tax return based on the taxable year of the entity on behalf of electing nonresident members reporting and paying income tax at the highest marginal rate provided in [state tax rate provision] on the member’s pro rata or distributive share of income of the pass-through entity from doing business in, or deriving income from sources within, this State.

D. A non-resident member of a pass-through entity whose only source of income within a state is from pass-through entities may elect to have the pass-through entities on composite returns filed pursuant to this section report and pay income tax due on the member’s pro rata or distributive share of income passed through to the member by each entity from doing business in, or deriving income from sources within, this State.

C. The [tax agency] may establish procedures or promulgate rules and regulations necessary to carry out the provisions of this section.

D. A nonresident member that has been included in a composite return may subsequently file [~~an individual~~] its own income tax return and shall receive credit for tax paid on the member’s behalf by the pass-through entity with the composite return.

EXHIBIT F

Section 3. Member Agreements; Mandatory Payments.

A. With respect to each of its non-resident members, a pass-through entity shall for each tax year (1) timely file with the [State taxing authority] an agreement as provided in subsection B, and (2) make a payment to the State ~~as~~ if required in subsection C. A pass-through entity that timely files an agreement as provided in subsection B with respect to a non-resident member for a tax year shall be considered to have timely filed such an agreement for each subsequent tax year.

B. The agreement referred to in subsection A is an agreement of the non-resident member

7. to be subject to the jurisdiction of the State for purposes of the collection of income taxes owed on the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State; and either
8. to be included on a composite return that is filed by the pass-through entity accompanied by payment of tax due on the member's income from the pass-through entity, or
9. to file a return in accordance with the provisions of [individual income tax return filing requirement] and to make timely payments of all taxes imposed on the member by this State with respect to the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State.

C. If no agreement is filed in which the non-resident member consents to be included in a composite return that the pass through entity does, in fact, file for any tax year and if the non-resident member fails to file a [state] ~~[individual]~~ income tax return reporting the member's pro rata or distributive share of the income of the pass-through entity from doing business in, or deriving income from sources within, this State or fails to pay any tax due thereon, the pass through entity shall be liable for tax on such income at the highest marginal rate applicable to ~~[individuals]~~ the member. The pass-through entity shall be entitled to recover the payment made pursuant to the previous sentence from the non-resident member on whose behalf it paid tax. The pass-through entity may withhold from any distribution to a member the income tax due to this State from the member on the distribution at the highest marginal rate. Any payment by the entity of the member's tax liability shall be credited to the member and the [tax agency] may inform the member of any such payment.

Revised Proposed Statutory Language on Reporting Options for
Non-resident Members of Pass-through Entities Substituting Withholding

[Additions are underlined, deletions ~~struck through~~]

Section 1. Definitions.

A. “Pass-through entity” means a corporation that for the applicable tax year is treated as an S Corporation under [IRC §1362(a), or State Tax Code §], and a general partnership, limited partnership, limited liability partnership, or limited liability company that for the applicable tax year is not taxed as a corporation [for federal tax purposes] [under the state’s check-the-box regulation];

B. “Member” means [optional additional language: *an individual who is*] a shareholder of an S corporation, a partner in a general partnership, a limited partnership, or a limited liability partnership, or a member of a limited liability company.

Section 2. Composite Return Authorized.

E. A pass-through entity may file a composite income tax return based on the taxable year of the entity on behalf of electing nonresident members reporting and paying income tax at the highest marginal rate provided in [state tax rate provision] on the member’s pro rata or distributive share of income of the pass-through entity from doing business in, or deriving income from sources within, this State.

F. A non-resident member of a pass-through entity whose only source of income within a state is from pass-through entities may elect to have the pass-through entities on composite returns filed pursuant to this section report and pay income tax due on the member’s pro rata or distributive share of income passed through to the member by each entity from doing business in, or deriving income from sources within, this State.

C. The [tax agency] may establish procedures or promulgate rules and regulations necessary to carry out the provisions of this section.

D. A nonresident member that has been included in a composite return may subsequently file ~~[an individual]~~ its own income tax return and shall receive credit for tax paid on the member’s behalf by the pass-through entity with the composite return.

EXHIBIT G

Section 3. Member Agreements; Mandatory Payments.

A. With respect to each of its non-resident members, a pass-through entity shall for each tax year (1) timely file with the [State taxing authority] an agreement as provided in subsection B, and (2) make a payment to the State as required in subsection C. A pass-through entity that timely files an agreement as provided in subsection B with respect to a non-resident member for a tax year shall be considered to have timely filed such an agreement for each subsequent tax year.

B. The agreement referred to in subsection A is an agreement of the non-resident member

1. to be subject to the jurisdiction of the State for purposes of the collection of income taxes owed on the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State; and either
2. to be included on a composite return that is filed by the pass-through entity accompanied by payment of tax due on the member's income from the pass-through entity, or
3. to have the pass-through entity withhold and pay over pursuant to [the state income tax withholding statute] income tax at the highest marginal rate provided in [state tax rate provision] due from that nonresident member on all distributions of income to that member by the pass-through entity from doing business in, or deriving income from sources within, this State. file a return in accordance with the provisions of [individual income tax return filing requirement] and to make timely payments of all taxes imposed on the member by this State with respect to the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State.

C. ~~—— If no agreement is filed in which the non-resident member consents to be included in a composite return that the pass-through entity does, in fact, file for any tax year and if the non-resident member fails to file a [state] individual income tax return reporting the member's pro rata or distributive share of the income of the pass-through entity from doing business in, or deriving income from sources within, this State or fails to pay any tax due thereon, the pass-through entity shall be liable for tax on such income at the highest marginal rate applicable to individuals. The pass-through entity shall be entitled to recover the~~

~~payment made pursuant to the previous sentence from the non-resident member on whose behalf it paid tax.~~

C. Each pass through entity shall for each nonresident member either file a composite return reporting and paying tax due from the member for any tax year, or withhold and pay over pursuant to [the state income tax withholding statute] income tax at the highest marginal rate provided in [state tax rate provision] due from the member on all distributions of income to that member by the pass-through entity. Any payment by the entity of the member's tax liability through composite return or withholding shall be credited to the member and the [tax agency] may inform the member of any such payment.